

Funding the Future

Disruptive Forces in Investing

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Anu Rajakumar: Asset owners are working to invest for the long-term future of their beneficiaries. Here at Neuberger Berman our ESG Advisory Council aims to bring the latest thoughts on sustainability into the heart of our business. My name is Anu Rajakumar, and today I'll be handing the mic to Jonathan Bailey, Head of ESG Investing here at Neuberger Berman as he welcomes to the podcast Theresa Whitmarsh, former CEO of the Washington State Investment Board and a member of our ESG Advisory Council. Jonathan, over to you.

Jonathan Bailey: Thank you, Anu, and thank you, Theresa, for joining us today for a discussion on ESG and long-term investing. So Theresa, you served the Washington State Investment Board for 18 years and 12 of those years as CEO. What can you tell us about your decision to serve the people of the State of Washington and your journey to leading the board?

Theresa Whitmarsh: Well, there's a theory put forward by a Stanford academic of how to attract talent to public service in the financial services industry. He calls it the three G's: green, gray or grounded. The green are those earlier in their careers looking to gain valuable experience on global portfolios. The gray, or what I call the Wall Street refugees, they want to do meaningful work at the end of their careers and give back after succession at commercial firms.

And then there's the grounded which comes to me. Those are people who want to come back to the community they were raised in, or stay in the communities in which they have deep roots. And so I fall into the grounded category. I have very deep roots in Washington State. I've lived 32 years on a ranch just south of Olympia, which is the state capital, where the WSIB is located. So when I was approached for this opportunity at the WSIB, it was a really easy trade off from my private sector experience. I could do fascinating, meaningful work and stay on my ranch.

Jonathan: I think you had an incredible track record in terms of delivering for the State of Washington employees who were participating in the plan. And part of that is your focus on the long term. And since you've retired from WSIB, you've taken on the role of Chair of the Board of FCLT Global, an organization whose mission is about focusing capital on the long term. Can you share more about why a long term investment mindset is key for asset owners?

Theresa: Sure. I think, frankly, it's the only mindset that makes sense for investors who have long dated liabilities. Our financial commitments to workers go out for decades, so our investing strategy must also be a multi-decade strategy. It's important to build resilient portfolios or what I would call an all-weather portfolio that will perform through multiple market cycles. And it's not easy to do but FCLT research shows that investors and companies that focus on the long term do outperform short term market timers.

Jonathan: So it's been a particularly volatile last 12 to 18 months and that sometimes makes investors nervous. How did you deal with volatility when you experienced it during those periods of change when you were running Washington State?

Theresa: Well, first of all, we made volatility not the most important risk measure. We had a whole number of other risk measures that we followed, volatility we observed, we paid attention to it, but we didn't make decisions based on short-term volatility.

Jonathan: So it's obviously one thing to talk about focusing on the long term, it's another thing to implement it. How did you go about either enhancing an existing long term mindset at WSIB or already creating one during your time leading the organization?

Theresa: Well, there's a little bit of both. Some of it was there when I arrived, certainly the commitment to private market assets which is naturally a long horizon investing strategy was already in place. But we did a number of things to enhance that. And I think several of the tools that I am probably most proud of in terms of having implemented and that were probably the most useful, one was just a very simple thing.

When I arrived, we reported performance on a monthly basis. Well, we dropped that and added the longer time horizons. We added the 10-20 year and the since inception performance number. So just to get the board focused on performance over time. I have a kind of an interesting anecdote. A new board member had just joined the board and she represented the retired

public employee. So she was not a financial expert at all, and the markets did a 100-200 basis point drop, like happens in a volatile market environment. And I got a call from her and she said, "Oh my goodness, how much did we lose today?" [chuckles] And I told her, "Well, you know, first of all, I don't even know that. We'd have to go calculate that but that's not the time horizon that we're focused on." And over time she gradually learned about our philosophy and our approach and became a strong proponent of it. So I think actually performance measurement and what you focus on is important.

But the other thing is we adopted investment beliefs that I really think become a touchstone whenever market events such as the great financial crisis challenged our conviction. We reviewed with staff and with our board our key investment beliefs, to see if we still had conviction in them. And if we did, we stayed the course. And then we did a couple other things.

We adopted and updated capital market assumptions biannually. So that gave us a chance every couple years with the board to once again decide whether or not we wanted to make modifications to our capital market assumptions. Did we believe the markets were gonna perform similarly going forward as historically? And in the end, this robust ongoing dialogue with the board and with staff and with key stakeholders, such as legislators, allowed us to stay the course despite incredible pressure during the financial crisis to not stay the course. And that certainly worked out well for us.

Jonathan: So one of the other ways that you were long-term oriented and a little differentiated than some other public plans in the US, was your degree of exposure to private markets, which obviously helps because of the lack of market to market with some smoothing in valuations relative to public market volatility. So what did you learn in growing the private markets allocation that might be helpful for some of our other investors to hear as they're considering doing the same thing?

Theresa: Well I think for one, go slow and deliberate, set an allocation, put your money to work in a what I would call a dollar cost averaging into the market. So every year you commit a certain amount and you don't try and select vintage years or game or time vintage years. Looking back on the history of our more than 40 years of private equity investing, what we found is that when we essentially put the same amount to work every year in the market we did way better.

And on the years when, as we called it the 'we were closed for business' PE firms were not making capital calls so that we were essentially underinvested in that particular vintage year. Those always turned out to be the really great vintage years. So, it's the same philosophy that we have with a lot of things is don't market time.

Jonathan: So you talked a little bit about stakeholders, and I'm sure you had stakeholders who had different views around some of the environmental, social and governance considerations that they thought you ought to have been considering in the way you ran the investment portfolio. And there has obviously been some discussion around whether ESG is a risk mitigant or potentially something that can be a distraction from delivering investment performance. And we know this is a more complex debate in the United States over the last year or so than perhaps has been in the past. So, as someone who's delivered outstanding investment returns and has considered environmental, social and governance factors, what advice do you have to investors as they think about trade-offs that may or may not exist around ESG?

Theresa: Well, I think it does come back to time horizon. And if you're a long horizon investor, externalities such as climate risk will eventually get priced in. So I think investors must pay attention to financial risks, but they also must pay attention to emerging risks that maybe we don't fully understand and have as accurate measures as we do say under financial risk. But bottom line, we need to pay attention to all the risks, including emerging risks that are less well-defined. That's just good underwriting from my perspective.

Jonathan: And as I've hinted at, it has become a little bit more controversial and politicized. So your day job, as you've talked about, is to, you know, preserve the future of retirements for the State of Washington employees, at least it was until you stepped down yourself. So how do you advise investors to navigate some of these buffeting political wins when really the long-term objective is one that should transcend short-term political and electoral cycles?

Theresa: Well, I think we have to cast the trade-off in a risk return framework. And so good investing's always been about underwriting risk. And as I said before, both known, well understood risks such as financial risk as well as emerging risks that we're just now defining and measuring. So the fact that we've put a label on emerging risks, the ESG label may be problematic because it does lead to ideology and ideological discussions. But risk is risk wherever you find it. And to manage for those risks is gonna give you a better return in the long run.

Jonathan: So, at Neuberger, like at any asset manager, our role is to serve our clients, and you work with a range of asset managers in your capacity at Washington State Investment Board. So how can asset owners advance long-term alignment and support

their external managers in achieving those objectives for them? And what lessons have you learned from trying to implement that in your partnerships with your managers?

Theresa: Well, I think how we measure our own internal team's performance, the benchmarks we use, the time horizon we use for those benchmarks and how we measure our investment manager's performance is really essential. We all respond to how we're measured and particularly incentive compensation schemes. So too many asset owners demand short term performance from their managers. So if we, as institutional investors, say we're long-term, but we fire a manager who underperforms for a quarter, then we've got a serious problem.

Jonathan: Well, Theresa, thank you so much for being with me today, and for all of your contributions to the Neuberger Berman ESG Advisory Council. It was a pleasure being with you today.

Theresa: Thank you. I enjoyed it.

Anu: Well that was a great way to kick off our ESG conversations for 2023. Many thanks to Jonathan Bailey and Theresa Whitmarsh for sharing their perspectives. And to our listeners, if you've enjoyed what you've heard today on Disruptive Forces, you can subscribe to the show via Apple podcast, Google podcast, or Spotify, or you can visit our website www.nb.com/disruptiveforces for previous episodes as well as more information about our firm and offerings.

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